Spotlight: Econ Op-eds in Summary

Week ended 22nd January '20

In Summary

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

1. Political Triumph and Economic Morass
By: Ahilan Kadirgamar

- The current economic dynamics of the country are crippling, with a large debt repayment falling due this year. This will have to be rolled over with more costly new loans amidst Sri Lanka being downgraded by rating agencies. The alternative option would be to start another IMF program or to borrow from large bilateral donor, both not very favourable for the country.

- Amidst such an economic backdrop, the government has projected a high GDP growth for the next few years. While these levels of growth had been achieved earlier, they were backed by investment in urban real estate and infrastructure. Without adequate domestic savings for investment and declining global appetite for investment in real estate, aiming for high growth will require privatisation and concessions to the private sector to entice foreign capital.

- The alternative for a small developing state amidst a global decline would be to reset our ambitions and settle on lower levels of GDP growth and instead redistribute wealth. This needs to be achieved through a change in the economic structure where the inequalities are reduced. This also needs to be done in a manner where we do not allow external powers to exploit the country's resources.

Economic challenges

For the current regime, their political and economic fortunes are diverging; the political situation is most favourable for consolidation, while the economic dynamics are crippling. A decade of post-war investments in large infrastructure and the related external debt have pushed the country into a debt trap. The large debt repayments on the order of US$ 4 bn due this year have to be rolled over with much more costly new loans, even as the rating agencies are downgrading Sri Lanka. Reduce the cost of borrowing from the global capital markets would mean, yet another IMF programme with its neo-liberal conditions attacking welfare measures for the people. The other option is to borrow from large bilateral donors who in turn will try to extract economic stakes to boost their geopolitical interests amidst hegemonic rivalries.

Into this difficult economic mix, the president has promised GDP growth of 6.5% over the next few years in his election manifesto. In the past, high GDP growth of 8% in 2010, 8.4% in 2011 and 9.1% of 2012 before it declined to 3.4% in 2013 and 5% in 2014 were a consequence of high levels of investment above 30% and even as high as 39% of GDP (Finance Ministry Annual Report 2018). However, such investment was not productive; investment in urban real estate and infrastructure increases GDP growth in the short-term by stimulating the construction sector, but does not lead to sustained growth as with investment in production including factories creating longer-term employment. Indeed, then as it is now, the bulk of foreign investment coming into Sri Lanka is focused on speculative build-out.

The recent tax cuts have reduced state revenues, and the government claim investment projects will only begin with their Budget after the elections. Without adequate domestic savings for investment and declining global appetite for investment in real estate, aiming for high growth will require privatisation and concessions to the private sector to entice foreign capital. Such neo-liberal economic policies come with risks of failure given the economic environment, and even if successful would mean dispossession for the people coupled with rising inequalities; for example, electricity, transport and educational costs will rise if those sectors are privatised.

Alternative trajectory

The question then is about the alternative. What can a small developing state do amidst global decline? It could be argued that we have to reset our ambitions and settle on lower levels of GDP growth, but with the political will to redistribute wealth. That means increasing direct taxes, including property and wealth taxes, which have to be redistributed through social welfare investment and services.

While the Government and our public commentators warn about the dangers of external extraction and imperialist inroads, they forget the class question that is at the root of imperialism. Extraction and exploitation of our resources, whether it is by the Americans or the Chinese, is linked to the class structure of Sri Lanka's capitalist economy. Rather than allow external powers and their agents in the form of local comprador elite to accumulate by dispossessing and exploiting our people, we need to change the structure of the economy and reduce inequalities, where extraction itself becomes difficult. In other words, it is far more difficult to extract from free education than fee levying private education, and say agricultural production for local consumption – for which there is still great demand – than cash crops produced for exports.

For the full article – Refer Daily Mirror

2. Limping merchandise exports: Gota should not make the same mistakes as the previous governments
By: W.A. Wijewardena

- Sri Lanka's exports have been struggling. The failure of previous governments to act upon the vital role of exports in economic development have hurt the economy. Despite policy statements during 2015-17, exports levels were almost the same levels recorded during 2012-14. Such statements along with the Vision 2025 policy document mainly identified the need for Sri Lanka to enter the global value chain.

- While the new export strategy in 2018 proposed to develop six selected areas, it did not expand on the main strategy proposed of joining global value chains. The targets presented could also be considered too ambitious for the current capacities of Sri Lanka. Achieving even a modest growth in export earnings in the next six-year period would require a special policy package.

- A lack of new products and having no proper action in developing export services have stunted the export growth. The cost advantages Sri Lanka had in textiles are threatened by growing trends of on-shoring and near-shoring. Thus, in rescuing the country's merchandise export sector, a comprehensive action plan, to diversify the exports and link them to global markets should be presented.

Sri Lanka's sluggish export performance

Sri Lanka's merchandise exports have been limping from around 2011. Exports which amounted to $ 10.6 bn in 2011 have changed at a very slow rate since then. During 2011-18, the average annual merchandise exports amounted to $ 10.75 bn. During the first 11 months of 2019, exports had grown by 1.7% to $ 10.7 bn. A prorated estimate will reveal that Sri Lanka could reach an export level of $ 11.7 bn in 2019. However, due to the high export performance in December 2018, this estimated annual performance records a decline of close to 2% in 2019.

The inactivity of previous governments

Exports have been the main source of Sri Lanka's import financing, wealth creation, employment generation, poverty alleviation, exchange rate stability and servicing the external debt obligations. The non-recognition of these vital roles played by exports and remaining inactive in the midst of a major economic crisis by both governments have driven the country to a critical level today. Hence, Gota's challenge has been to break loose from the past fetters and implement an immediate action program to reverse the ominous trend.

Sri Lanka's sluggish export performance during 2011-14 was evident in the first economic policy statement presented in Parliament in November 2015. The issues relating to exports and strategies to be adopted to resolve them had not been presented in the statement under one heading. Hence, one has to undertake the laborious task of piecing together the numerous references made in different places to exports to gauge the government's strategy on the issue.

Recognising the importance of exports in increasing the welfare of people, the previous government had emphasised that Sri Lanka should produce for a market larger than that in the country. For that purpose, the country should find space in the world market. That space would be harnessed by entering into formal trade agreements with India and China which will offer a market as large as 2.5 bn people to Sri Lanka's exporters. The strategy to be adopted by this government, was to link Sri Lanka to the global value chain. This requires empowering the country with high technology. To acquire high technology, 11 business and technology development areas will be established throughout the island. The local and foreign investors who are to invest in Sri Lanka under the government's incentive schemes will be linked to this value chain.

Export targets should not be mere wishes

It had correctly identified that to have a high growth in exports, Sri Lanka needed to have a major capital infusion and greater investments. To attain better results, Sri Lanka should go for new technological innovations, better management of data systems and up to date market information systems, the policy statement opined.

Lamenting over Sri Lanka's lagging behind both Bangladesh and Vietnam which were pretty much below the country in export performance a few decades earlier, the second policy statement promised to create a suitable climate for investments to take place in the export sector in the country. While foreign investors were to be used as a vehicle to join the value chain, the government promised to help local investors too to join the same. In this manner, the proclaimed goal of the government, as pronounced in both policy statements, was to direct all investments toward achieving a higher export growth.

But the promises made in the second economic policy statement too remained mere wishes with no practical application. Consequently, exports continued to show a sluggish performance in the first three years of the administration. The annual average export level during 2015-17 amounted to just $ 10.7 bn marking almost the same level recorded during 2012-14.

The new export strategy was no better

However, the New Export Strategy had been silent on the main strategy proposed, Sri Lanka's joining the value chain or the global production networks. Instead, it had proposed to develop six selected areas of exports – two already mature, two emerging and two visionary sectors – which the designers of the strategy had considered as important for Sri Lanka to increase its export earnings quickly.

Though the designers of the new export strategy had been working on a set of internal physical targets for merchandise exports over the planned period, they had not been revealed in the document containing the national export strategy. These internal targets had envisaged Sri Lanka to increase its earnings from merchandise exports at an exponential rate of 11% during 2017 to 2025.

The ambitious targets in the strategy

This strategy was also not implemented by the Government like the previous economic policy statements and the Vision 2025. As a result, the actual export performance fell far below the targets. In 2018, the plan had envisaged to earn $ 13.1 bn through merchandise exports. But the actual realisation was $ 11.9 bn only. Similarly, in 2019, the target of export earnings was $ 15.1 bn. But the developments so far in the export sector shows that the country would not be able to earn more than $ 11.7 bn.

It is inevitable that the same fate would befall on the targets for the rest of the period too. The exponentially growing exports are to reach, according to the internal targets, $ 17.4 bn in 2020, $ 19.1 in 2021, $ 21 bn in 2022, $ 23.1 in 2023, $ 25.4 bn in 2024 and $ 27 bn in 2025. As it is, the installed capacity – technological as well as managerial – would not permit Sri Lanka to reach these targets.

Even a modest growth in export earnings in the next six-year period would require Sri Lanka to adopt a special policy package relating to the export sector.

Sri Lanka's saturated export structure

As at today, Sri Lanka's exports are being dominated by two product categories, apparels and 'the three tree crops' – tea, raw rubber and coconut. In 2017 in which its exports figures were the highest in the recent years, the former accounted for 44%, while the latter 'three tree crops' had a share of 17% of total export of goods. A brand-new category that had been added in the recent decades had been manufactured rubber products – mainly solid tyres – that had acquired a share of 7%.

This has been the country's export structure in the last four decades and it had been happily savouring marginal improvements in these categories whenever such improvements occurred. That complacency had sowed the risk viruses that have stunted its growth as a mature growth sector.

On the one hand, they had already reached the saturated point given the country's limited resource base. On the other, there were no new products added to the list, and worse, no concerted action had been taken to charter the unchartered territory of 'services. With proper logistics in place and elimination of unfriendly policies, services offer a good opportunity for Sri Lanka to bring its own next big thing in expanding the earnings base in foreign exchange.

Sri Lanka's main manufactured export – textiles and garments – face a major challenge due to two related developments. The textiles and garments sector benefitted from the wave of globalisation that took place in the global economy in 1980s. Accordingly, the rich countries in the world taking advantage of the low wage costs in low income countries

began to set up their mass consumption product factories in the latter category of countries. This process was known as off-shoring.

New production model to replace off-shoring by on-shoring and near-shoring

A recent survey conducted by McKinsey and Company on the apparel sectors in North America and Europe has revealed that both near-shoring and on-shoring have become the most popular production model adopted by a large segment in the final consumer countries.

In the past, fashions developed by apparel companies had been forced on consumers. But that trend is fast changing and instead, a bottom-up consumer preference system in which the consumers will inform garment manufacturers to produce the fashions they desire is developing in the apparel sector. To gain capacity to produce and supply these products, apparel trading companies need to have manufacturing facilities near the markets. That is the reason for near-shoring and on-shoring to get established in the apparel sector value chain. On-shoring has been facilitated by automation of apparel manufacturing brought in by such technological advancements as 3D print manufacturing, gluing and bonding instead of stitching and robotic employment.

As a result, the cost advantage enjoyed by low income countries like Sri Lanka with respect to garment manufacturing is fast eroding.

Will Sri Lanka lose its markets?

Both North America and Europe are Sri Lanka's established markets for apparel products. During the five-year period from 2013 to 2017, European Union absorbed 43% of Sri Lanka's apparel exports, while North America absorbed 46%. Thus, these two markets had accounted for 89% of the country's apparel exports. Accordingly, if they are to near-shore and on-shore apparel supplies, Sri Lanka's traditional apparel industry will face a serious risk of maintaining sustainability. It is therefore necessary for Sri Lanka to change the focus of its production to new export commodities to avert possible downside development of its export sector.

This is the challenge faced by Gota in rescuing the country's merchandise export sector. He should present a comprehensive action plan, with time bound targets, to diversify the country's merchandise exports and link them to global markets by activating all the possible global production networks.

For the full article – Refer DailyFT

3. Why foreign earnings could solve the debt problem
By: Waruna Singappuli, CFA

- The external current account and the budget deficit tend to move in opposite directions. While import restrictions in 2019 contracted the current account deficit, the subsequent reduction in tax revenue widened the fiscal deficit. Both these factors, along with foreign earnings, drive the country's debt levels.

- The need to borrow around USD 2 bn annually to finance this import bill (in addition to existing debt servicing) leads to calls for import restrictions. However, growth-focused long run measures such as moving importers towards value addition and import substitution activities can be preferable to import restrictions, as the latter can tend to weaken the economy and stifle growth.

- The sustainability of inflows to the treasury market and FDIs are uncertain as they depend heavily on external developments. Instead, developing foreign currency earnings would be a more stable and sustainable solution to the debt problem. Despite this being cumbersome and time consuming, it is one of the most important measures to solve the country's debt problems.

Difference between external current account and budget deficit

The external current account and the budget deficit move in opposite directions. Government revenue is directly linked to imports, while the export sector enjoys concessionary taxes. A surge in imports may actually reduce the fiscal deficit through higher tax revenue although worsen the external current account deficit.

The sharp fall in imports due to import restriction measures have significantly contracted the deficit in the external current account in 2019. However, it also affected tax revenues, negatively resulting in an expansion of the fiscal deficit.

A deterioration of the fiscal deficit through incentives and expenditure related to boosting foreign currency earnings would have been positive. Instead, it happened due to import restriction measures, which has weakened the economy, resulting in a GDP growth close to 2% and distress in many sectors. Imports shouldn't be restricted through such knee-jerk reactions, instead through long term measures such as shifting importers for value addition, import substitution type activities.

Link between foreign debt and external current account deficit

The deficit in the external current account drives the foreign debt. Foreign inflows/outflows to/from the Treasury Bond market has either eased or aggravated the need for foreign borrowings. Clearly seen in 2015, the external current account deficit was USD 1.9 bn, foreign outflows from the treasury bill market was $ 1.1 bn. The increase in foreign debt was the addition of the two at $ 3.0 bn.

The increase in foreign debt is markedly higher from 2016-2018, possibly because the Central Bank could have been trying to boost the foreign reserves to meet the stiff foreign debt repayment obligations in 2019-2020. 2019H1 also clearly shows that as the deficit in external current account was sharply lower, the need for foreign borrowings has also been significantly less.

If import restrictions are not imposed, Sri Lanka would need to borrow around $ 2 bn annually to finance the import bill in addition to debt repayments in the near term

Why foreign earnings rather than inflows to bonds and FDIs?

Prior to 2015, inflows to the Treasury Bond market and/or FDIs were able to reduce the need for foreign borrowings. However, unlike foreign currency earnings, sustainability of inflows to the treasury market and FDIs are uncertain. These inflows can easily be reversed depending on many external factors. Letting the Rupee appreciate at times when foreign inflows occur would negatively affect foreign currency earning segments and could actually worsen the foreign debt repayment capacity in the long term.

Developing foreign currency earnings would be a more stable and sustainable solution to the debt problem. Despite this being cumbersome and time consuming, it is essential and must be done immediately.

For the full article – Refer Daily FT

4. US-Iran standoff could hurt South Asia
By: Dinesh Weerakkody

- The recent tensions in the Middle East between USA and Iran have increased destabilisation in the region. While China has major interests in Iran, they will be careful to not hurt their ongoing trade negotiations with USA. These developments are critical for South Asia, where most economies are struggling with low growth and high inflation.

- While oil prices have risen, further escalations can threaten to disrupt upto 25% of the global oil traffic. This, along with the impact for the Middle East demand on South Asian labour can have negative implications for South Asia. Also, the tensions have resulted in investors moving away from emerging market bonds and stocks, to the safety of the USD and gold.

- The higher potential for escalation in tensions creates more uncertainty in the region. While escalations would be disastrous for South Asian equity markets, subsequent increase oil prices would lead to inflation. South Asian markets will certainly have to rely on their central banks to protect them from any future global shocks.

The killing of the second most powerful leader in Iran by the US military a few days back immediately resulted in investors fleeing away from volatile assets destabilising the region once again. The US could very well deploy additional military resources to the Middle East, a strategy that could lead to additional Iranian provocations. And that new risk to US security would occur at a time of mounting challenges to US interests elsewhere in the world and the challenges faced by President Trump domestically.

Iran's potential response, and the risk of broader escalation after the assassination of Soleimani has now enabled Iran's supporters to portray the US as a bully and shifted the discussion to one of a political and economic struggle against US imperialism, a timely diversion for Iran. Also, amid US-led sanctions, China meanwhile has become Iran's economic lifeline alongside Russia. China has committed itself to an unprecedented $ 400+ billion of investment in the Iranian economy, including in infrastructure such as dams, factories, airports, roadways and Tehran's subway system. Iran is also China's most important supplier of oil – something that would be put at risk in a conflict.

However, China would very likely to continue to tread carefully. They would certainly not want to hurt US interest that may result in unbuckling the ongoing trade negotiations which finally seem to be moving forward positively after nearly two years of painstaking negotiations.

South Asia

The new developments in the Middle East could not have come at a worse time for South Asia. With the region languishing at a sub 3-5% GDP growth for the past two quarters, and inflation overshooting the 5% mark in most markets largely driven by high prices of food. Therefore, the last thing that the region wanted was an exterior shock that would make matters worse economically and politically.

Therefore the killing of Major General Qasem Soleimani in an airstrike in Iraq by US forces has not only brought the Middle East on the brink of war once again, it has cast a huge shadow on the economies of hugely oil-dependent countries in South Asia, who have gone for big tax cuts and further sectoral stimulus to kickstart their economies. The Middle East crisis raises serious questions on the impact on countries like India and Pakistan and

Bangladesh of a fresh escalation in tensions in the region and through this for the demand for South Asia's labour. A surge in international oil prices could therefore have negative implications for regional economic activity in 2020.

On the other hand, increased tensions have been causing precious metal prices like gold to rise. The price of Brent crude has risen by 20% in the past three months in USD terms, Iran has the potential to produce up to 4.0 m barrels of oil per day, equivalent to 3.7% of global demand and around 12.5% of total OPEC supply. Worse still, an escalation of tension could threaten to close the Straits of Hormuz through which a huge portion of the oil traffic from the Gulf region moves, it could disrupt up to around 25% of global oil traffic.

Also, the other risk for South Asia is that investors who had boldly bought into emerging market assets such as government bonds and stocks, will be compelled by their conservative shareholders to sell out of some of these assets and to move into the safety of the USD and gold. The sudden increase of gold prices reflects the appetite for safe assets that does not come with negative returns.

Future prospects

According to analysts an unpredictable Trump seeking re-election and a cornered Iranian leader, the cycle of retaliatory violence could certainly easily escalate out of control. Trump having executed a flawless precision strike has boasted that he would hit very fast and very hard to protect US diplomats and service members in the region. This threat will continue to create uncertainty in the region and will have a toll on Asian markets. Any further escalation therefore from now on would be disastrous for South Asian equity markets.

Gold as a safe haven and oil prices at $ 70 is certainly a worrying trend for South Asia. Therefore, any increase in the price of crude oil would tend to impact the inflation number commensurately and COL. South Asian markets will certainly have to rely on their central banks to protect them from any future global shocks through their monetary policy actions and exchange rates and also come up with some unconventional monetary policy tools.

The general consensus is that the global economy still faces multiple economic and political headwinds and any growth cannot be taken for granted. Therefore, the Middle East crisis raises serious questions on the impact on South Asia in general of a fresh escalation in tensions in the oil rich region.

For the full article – Refer Daily FT

Disclaimer: This information has been compiled from sources believed to be reliable but Frontier Research Private Limited does not warrant its completeness or accuracy. The bullet points provided for each summarised opinion article is written by Frontier Research and has no connection to the respective author. Furthermore, the information contained in these reports/emails are confidential and should not be shared publicly. Disclosure, copying and distribution is strictly prohibited.