Spotlight: Econ Op-eds in Summary

Week ended 6th October '21

In Summary

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

1. Central Bank's Road Map lacks monetary policy framework, avoids IMF bailout
By: Professor Sirimevan Colombage

- The recently presented CBSL Roadmap does not provide a coherent monetary policy framework, which could lead to surges in market liquidity and exert severe pressure on the external sector and inflation.

- The roadmap forces exporters to convert the required levels of foreign exchange within a stipulated time frame. While exporters have denied claims of hoarding foreign currency, it is natural for exporters to expect the rupee to depreciate and to borrow locally to ensure forex earnings are stable under given circumstances.

- The negotiation of an IMF program would mean that Sri Lanka would adopt necessary structural reforms as part of the program, which would allow for greater foreign investor credibility in the country allowing it to attract more FDI. However, the Roadmap rules out IMF support, and in doing so, would incur enormous adjustment costs on the public.

Amidst a severe economic crisis facing Sri Lanka characterised by heavy debt commitments, fiscal imbalance, international reserve depletion, rupee depreciation, import shortages, and inflationary pressures, the Central Bank of Sri Lanka (CBSL) has become dysfunctional in its key role – monetary policy operation. The market players who act rationally are far ahead of the policymakers, and eventually, the CBSL has lost its grip on both the exchange rate and interest rates.

Six-month Road Map

It is in this background that the CBSL Governor Ajith Nivard Cabraal presented the six-month Road Map last week. While it contains a long "to-do-list" of measures, it does not present any coherent monetary policy framework, which is the prime responsibility of the CBSL, to tackle the macroeconomic imbalances mentioned above.

For example, instead of devising a flexible exchange rate and interest rate mechanism to overcome the foreign exchange crisis, the Governor accused the exporters of "hoarding" their foreign exchange earnings abroad and threatened them with heavy tax penalties. While avoiding an IMF bailout, even the much-publicised home-grown policies are missing in the Road Map.

With its home-grown policies sans IMF bailout, the CBSL has no option other than to continue money creation and anti-market monetary controls. In the absence of a robust monetary policy framework, the surge in market liquidity will continue exerting severe demand pressures on the exchange rate, imports, and inflation.

CBSL plays a passive role

While attempting to maintain a fixed exchange rate since last year, the CBSL has accommodated excessive Government borrowings by purchasing Treasury bills and bonds in the primary market causing a rapid increase in the currency issues, which is commonly known as money printing. Hence, the CBSL is unable to use Open Market Operations, which is a key monetary policy instrument, to sell those securities for mopping up excess liquidity. Also, it does not have much space to increase the policy interest rates to reduce bank credit due to possible cost implications for the public debt.

Thus, the CBSL plays a passive role as regards its key monetary policy instruments: open market operations, policy interest rates, and exchange rate management. The Road Map does not attempt to reactivate the now-defunct monetary policy.

Exporters whipped

Presenting the Road Map, Governor Cabraal warned, "We will strengthen mandatory conversion of export proceeds and request the government to tax profits of exporters at 28% instead of 14% where the foreign exchange is not repatriated and converted."

Instead of addressing the problem of the alleged delays in the repatriation of export proceeds through market-based monetary policy instruments such as exchange rate and interest rate flexibility, the CBSL has opted to whip the exporters, unmindful of the adverse consequences.

Speculation in the forex market

The CBSL, in an unusual press notice issued last week states, "It also appears that due to undue speculation on exchange rate movements, there has been a reluctance to convert export earnings during the period from January 2020 to July 2021, thereby limiting inflows to the domestic foreign exchange market. … In addition, with low rupee interest rates, some exporters have found it more lucrative to borrow and import to meet their input requirements, leading to further tension in the domestic market."

Thus, the CBSL admits that there is market speculation on exchange rate movements. This implies that the market players have no confidence in the exchange rate margins declared by the CBSL, and they expect further depreciation of the rupee. Ironically, the CBSL also confesses that some exporters tend to borrow locally at low interest rates to meet their import outlays.

Impossible trinity

The above speculative environment is created by the CBSL itself, and therefore, it is unfair to accuse the exporters who act rationally forming their expectations about future behaviour exchange rate and interest rate movements.

No central bank in the world can escape the hard principle of "Policy Trilemma" or "Impossible Trinity" in Economic Theory. It means that a central bank cannot fix the exchange rate and interest rates at the same time without entertaining capital outflows. As the CBSL has anchored both the exchange rate and interest rates simultaneously, exporters act wisely to keep their export earnings abroad anticipating rupee depreciation, and borrow locally taking advantage of low interest rates.

Exporters disappointed

The CBSL's press notice further states, "As would be well appreciated, an export would realise its objective only when it finally culminates in the flow of foreign exchange that is generated by the export into the country's financial system in its local currency. That objective would obviously not be fulfilled if the final conversion of export proceeds into local currency does not take place. Accordingly, steps must be taken to strengthen the systems to ensure monitoring and to implement measures that lead to this objective. It is only then that the gap between the foreign exchange liquidity provided through exports and the foreign exchange liquidity demand for imports would reduce to the level as published in the Central Bank's own reports."

The Exporters' Association, the Joint Apparel Association Forum, and the Sri Lanka Association of Manufacturers and Exporters of Rubber Products have categorically denied the CBSL's allegation of 'hoarding' foreign currency earnings. They are deeply disturbed by the negative connotations and inferences cast on the export sector by the CBSL in its press notice.

Road Map silent on fiscal expansion

The under-subscription to the extent of 40% in the Treasury bill auction held last week indicates that the marginally increased cut-off yield rates are insufficient to sell the entire bill stock to the market. The balance portion of the Treasury bills was to be purchased by the CBSL causing a rise in its monetary base, and in turn, the currency issue and the aggregate money supply.

The Road Map is silent on such fiscal dominance which restricts the space available to conduct monetary policy.

IMF bailout not on the cards

The Road Map rules out seeking assistance from the IMF. Given the foreign exchange shortages compounded by the heavy external debt commitments, it would be ideal to enter into an agreement with the IMF to ease the balance of payments difficulties.

Such an arrangement would provide sufficient breathing space to implement the adjustment policies that are essential to restore economic stability and facilitate economic growth.

The IMF's lending conditions are designed to execute its loan facilities and to ensure that the borrowing country will adopt the policy reforms that are needed to restore macroeconomic stability, particularly concerning the fiscal sector and balance of payments.

IMF programs not only help to reduce the risk of loan default but also confer a "seal of approval" regarding the credibility of the macroeconomic policies. This enables the country to borrow from capital markets at a low cost and to attract Foreign Direct Investment (FDI).

Continuous borrowing from sources other than the IMF has become the preferred choice of the country's top policymakers. For example, it is reported that discussions with the Chinese Government are currently in progress to purchase fuel for six months on a Sovereign Bond. such commercial borrowings will further aggravate the debt crisis.

The IMF assistance is subject to the borrowing country's obligation to implement the conditionalities aimed at improving government finances and external payments. These conditionalities, known as "structural adjustment policies", include budget deficit reduction, removing price controls and state subsidies, privatising state-owned enterprises, liberalising foreign trade and exchange systems, adopting flexible interest and exchange rates, and removing barriers to foreign capital flows.

As the CBSL is not in favour of an IMF program, Sri Lanka will have to bear huge adjustment costs in time to come to rectify the grave macroeconomic imbalances, causing enormous hardships to the people.

[For the full article – Refer Daily FT]

2. Severe shortages of external finances leading to economic deprivations
By Nimal Sanderatne

- Shortages of foreign currency and inappropriate policies seems to have created shortages in necessities in Sri Lanka, with large amounts of essential imports being stuck at ports. While the Central Bank had intervened and cleared part of these goods, this might not be a permanent solution for the shortage in essential items.

- On the other hand, the Lack of fertilizer may decrease Maha harvest as well as tea and rubber production in Sri Lanka. Further, the inability to import raw materials will decrease the export capacity of the country. The lack of foreign currency is exacerbated by a decrease in remittances, due to the considerable gap between the official and black market rate.

- The solution for the problem lies with addressing the fundamental problem in the external finances. This can be done in three steps. Abandoning the administered exchange rate, seeking emergency foreign assistance from friendly countries and asking for emergency balance of payments support from the International Monetary Fund (IMF).

Critically low

The depletion in external finances reached such critically low levels that large amounts of essential imports were stuck at the port as banks did not release foreign currency to honour the letters of credit (LCs). Such is the severity of this financial crunch.

Ominous

Even more ominous was the report that "overseas corresponding banks are refusing letters of credit from local banks." This in effect means that the country is unable to import. An early resolution of this problem is of utmost importance.

Puzzle

Even though foreign reserves have dipped to as low as about US$ 2.5 bn, it is difficult to understand why a relatively small amount of about US$ 25 mn or even US$ 50 mn could not have been released. The only plausible explanation is that banks did not want to sell foreign exchange at the low official rate when the market rate was much higher—nearly Rs. 50 or 25% more.

Serious implication

The serious implication of this situation is that the country is unable to import essential food items and much needed raw materials for industry. This would create severe shortages of food, medicines, petroleum, gas and other essential imports.

Releasing exchange

The government has now decided to release foreign currency to meet this immediate crisis. The Central Bank of Sri Lanka (CBSL) released US$ 50 mn to the two state banks to clear containers with essential goods that were stuck at the Colombo Port for weeks.

Prime Minister Mahinda Rajapaksa instructed the Controller General of Imports and Exports and the Customs Director General to immediately release 800 containers of essential food items which are stuck at the Colombo Port due to the failure by banks to release foreign exchange to importers. It is understood that the CBSL funds released yesterday could clear 400 such containers.

There are about another 400 such containers of essential commodities to clear. CBSL, it is understood, will release more funds, if needed, to clear more containers containing essential imports.

Food availability

The available food stocks are estimated to be adequate only till the end of October. May be we can stretch it a little further towards the end of the year. With a lower Maha harvest early next year owing to the lack of fertilizer, insecticides and fungicides, food availability could be a grave problem.

The current problem

While the underlying reasons for the depletion of foreign reserves is well known, the cause for the current unavailability of foreign exchange is the wide gap between the official exchange rate imposed by the Central Bank and the market or black market rate. While the official exchange rate is around Rs. 205 for a US dollar, the market determined exchange rate is around Rs. 245 for a US dollar.

Export earnings and remittances

This has led to several problems like non remittance of export proceeds, reduced foreign remittances and the unavailability of funds to clear cargo or open letters of credit for imports. We are not receiving export proceeds, remittances are declining and the black market in foreign currencies is thriving.

Impact

The inability to import raw materials will decrease our export capacity and earnings. Moreover, tea and rubber production would fall appreciably owing to the ban on fertilizer, weedicides and fungicides, causing a severe drop in their exports and manufactured rubber exports.

Remittances

Remittances, that rose till June has dipped since then owing to persons remitting dollars through informal sources that pay as much as forty to fifty rupees more for a US dollar. This decrease has been erroneously attributed to lesser workers in the Middle East.

The crisis

The consequences of the emerging crisis in external finances are horrendous. Are we heading to a Lebanon type catastrophe?

Overcoming the crisis

At this critical juncture we must address the immediate crisis first. The immediate task is to obtain international assistance to augment the reserves adequately to remove the stranglehold on imports. This requires to be addressed in three ways.

1. **Abandon the administered exchange rate and allow the market rate to prevail.**

Such an exchange rate policy will likely sky rocket the exchange rate to much above the official exchange rate and perhaps, even the current black market rate. This can only be found out after the change. There are also possibilities of it being lower than the market rate, but higher than the official rate if there are foreign currency inflows.

2. **Seek emergency foreign assistance from friendly countries.**

The Government has taken steps in this direction already. The Foreign Minister has approached the UAE and Iran for oil on credit. The Government has also requested another currency swap arrangement of US$ 500 mn from India. There may be similar overtures to other countries. What success these have met with is still unknown. Their success is of immediate importance.

3. **Ask for emergency balance of payments support from the International Monetary Fund (IMF).**

This is the best and least costly and most beneficial policy option both for the resolution of the immediate and long term problem.

Concluding reflections

The severity of the crisis is not only what it is today, but what it will be tomorrow. Soon there would be severe shortages and restrictions in the availability of petrol, gas, basic foods, and medicines as foreign exchange dips to lower levels.

The severity of the foreign currency crisis demands wiser counsel than prevails. There are signs that such pragmatism prevails in a pivotal position and that the government is moving in such a direction. It is a Hobson's choice.

For full article – Refer The Sunday Times